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ABSTRACT

This report uses government data to review current, past, and proposed tax-based policies and programs to promote college affordability as well as need-based grant aid. Tax-incentive-based programs include savings bonds for education, employer-provided educational assistance, state college savings plans, deductibility of student loan interest, exclusion of scholarships and fellowships from taxable income, expanded Individual Retirement Accounts and/or special education savings accounts, and tuition tax deductions and credits. Major findings of the analysis indicate that: (1) despite increasing evidence that the investment in need-based student aid has positively impacted equal educational opportunity, students from high-income families still have higher college-going rates than do students from middle- and low-income families; (2) the majority of grant-aid recipients are students from the lowest income groups who attend public colleges and universities; (3) tax deductions and other uses of the tax code have been most beneficial to taxpayers with high incomes; (4) the current use of tax-based assistance for higher education is modest; and (5) proposed strategies to increase the use of tax-based assistance could benefit families who already take advantage of the tax code. These findings are documented in chapters discussing grant-aid recipients, beneficiaries of tax policies, and proposed federal tax policies. (Contains 36 reference endnotes.) (DB)

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TAXING MATTERS

COLLEGE AID, TAX POLICY & EQUAL OPPORTUNITY

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TERI's Higher Education Information Center (HEIC) division receives funds from federal, state, and private grants, membership fees from colleges and universities, and other sources. These revenues are used to provide information at no cost to students and their families about financial aid for post-high school education and career opportunities.

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Executive Summary

Deductions, credits, and other tax-based provisions have been a prominent part of the national dialogue concerning college affordability in the last year. Although tax breaks to help ease the costs of paying for college have existed in various forms for years, the latest wave of discussion is unprecedented. In Washington, the budget cutting themes and austerity that have dominated national political debates have been joined with policy discussions about the plight of the middle-income family—stagnant income, spiraling higher education costs, and limited resources for assistance. These dual policy tracks have been aligned through the proposal of tax breaks to help students and families pay for college. Such policy proposals are drawn from decades of policy discussions about using the federal and state tax systems to provide support for students to attend college.

Despite the fact that many of these tax-based approaches to help students and families pay for college are based on arcane or complex provisions of the tax code, they have endured. The impact of these provisions, and their relationship to the more traditional need-based student aid programs such as Pell Grants, is therefore difficult to assess.

Many of these proposals have just begun the arduous journey through the legislative process. The scrutiny that they must face should be grounded in a balanced discussion of the benefits and drawbacks of increased use of tax-based aid to pay for higher education. To inform the policy process, The Institute for Higher Education Policy and The Education Resources Institute (TERI) have prepared this report. The goal of the report is to provide the public, policymakers, and the higher education community with essential facts and information about the variety of tax-based methods available to help pay for college, and to compare these with need-based aid policies.

To meet this goal, the report serves as a "primer" on the various means through which tax-based policies have been promulgated to promote college affordability. The report reviews current, past, and proposed policies and programs, and discusses who benefits from these policies, based

on available government data. The report also reviews similar information about need-based grant aid, which is targeted to lower-income students.

There are currently a variety of actual and proposed methods through which tax incentive-based assistance can help families pay for college. These include:

- *Savings bonds for education*: government bonds that feature interest exclusions if they are used to pay for higher education;
- *Employer-provided educational assistance*: four separate provisions in the federal tax code govern the deduction of education and training expenses that are either part of an employee benefits package or reimbursed;
- *State college savings plans*: many states have recently established programs that include savings bonds, savings accounts, or prepayment of college tuition;
- *Deductibility of student loan interest*: upon repayment, participants in federal student loan programs would be able to deduct annually a percentage of the interest paid;
- *Exclusion of scholarships and fellowships from taxable income*: recipients would not be liable for taxes on the amounts of assistance received in these forms;
- *Expanded Individual Retirement Accounts(IRAs) and/or the creation of special education savings accounts*: income eligibility ceilings for deductible contributions made to IRAs would be raised, or penalty-free withdrawals for education expenses from either a standard IRA or a new specialized account would be allowed; and
- *Tuition tax deductions and credits*: students and their families would be allowed to deduct up to a certain amount of education expenditures from their taxable income, or could receive a credit for their tuition expenses against the amount of taxes owed.

Major Findings

An examination of data and analyses from the U.S. Treasury Department, U.S. Department of Education, state governments, and other sources reveals several key findings:

Despite increasing evidence that the investment in need-based student aid has positively impacted equal educational opportunity, students from higher income families still have the highest college-going rates compared to middle- and low-income families. The percentage of high school graduates going on to college has increased from 51% in 1965 to 62% in 1995. But according to Census Bureau data, the college participation rate in 1994 for students from the lowest quartile of family income was 58%, compared to a rate of 88% for students from the

highest quartile of family income. In addition, recent research that tracked eighth graders from 1988 found that socioeconomic status is still the most important indicator of whether students will attend college, and where they will go.

The majority of grant aid recipients are students from the lowest income groups who attend public colleges and universities. Among students receiving Pell Grants—the federal program designed to serve as the foundation for student aid packages—25% of dependent recipients and almost 66% of independent recipients had incomes under $9,000 in 1994-95. The vast majority of Pell Grant recipients—69%—attended public two- and four-year institutions.

Tax deductions and other uses of the tax code have been more beneficial to taxpayers with higher incomes. In 1995, fewer low-income taxpayers itemized deductions on their federal income tax returns compared to those with higher incomes. Although taxpayers with incomes under $30,000 filed 53% of all returns, they represented only 9% of those who itemized, while taxpayers in the $30,000 to $100,000 income range accounted for 42% of all returns filed and 71% of those who itemized. Research indicates that the primary reasons for this disparity include: the limited availability of discretionary income among low-income taxpayers; an increased familiarity with and knowledge of the tax system among higher income taxpayers; and the proportion of benefits that higher income individuals and families receive.

The current use of tax-based assistance for higher education is modest. The current federal tax code provides for special education savings bonds and favorable treatment for employer-provided educational assistance and employee benefits. Public awareness of these provisions is limited and participation rates are low. For example, in 1994 approximately 900,000 employees received assistance for education expenses under Section 127 of the tax code, but they represented less than 10% of the eligible employees at companies that provided such benefits.

Proposed strategies to increase the use of tax-based assistance could benefit families who already take advantage of the tax code. For example, current proposals—such as IRAs for education—most likely would not affect low-income families. In 1985, the year when deductions for IRA contributions were highest, less than 14% of taxpayers with incomes between $10,000 and $30,000 claimed the deduction, versus 74.1% of those with incomes between $75,000 and $100,000. Similarly, the Congressional Budget Office estimates that proposed tax deductions for tuition would primarily benefit higher income families. Even though 60% of the families eligible to claim the deduction would have incomes under $50,000, the 40% of recipients with incomes above $50,000 would receive more than half the total amount deducted by all taxpayers.

IMPLICATIONS

The emergence of tax-based methods to improve college affordability hold great promise for helping to reduce the burdens that students and families face in paying for college. The public focus on increasing investment in higher education as a means of enhancing the nation's economic and social prosperity represents a sharp turn from policy discussions in recent years, which focused on the limited governmental resources available for such "discretionary" expenses.

Nevertheless, the dramatic surge in interest about tax-based methods also poses a challenge. The challenge is to find ways to promote affordability for middle-income families—the explicitly intended beneficiaries of most of these tax policies—without detracting from efforts to support access for those with the greatest need. This will not be an easy task because middle- and upper-income families rely substantially on tax-based methods of government assistance, which have significant political and policy advantages. These include:

- **The Budget Process:** Tax provisions, once enacted, do not have to receive authorization and appropriations each year; student aid provisions are not only subject to the annual budget process, but face competition for money within the discretionary portion of the federal budget. Furthermore, expanded use of tax provisions means a loss of federal revenues that places an even greater strain on the budget process. The lost revenues must either be made up by new revenues in the form of increased taxes or through further cuts in discretionary spending, placing expenditures for student aid in an even more precarious position.

- **Oversight:** Tax provisions are less frequently reviewed. When provisions are revoked, it is usually due to funding constraints, rather than a lack of participation or effectiveness, or even fraud and abuse. Student aid programs face the scrutiny of authorizing, appropriations, and oversight committees in both chambers of the Congress, and must also undergo a complete review every five years when the Higher Education Act—the major legislation enabling the federal student aid programs—is reauthorized.

- **Public Support and Political Will:** If the needs of low- and middle-income families for assistance in paying for college are addressed through two distinct vehicles, the support for inclusion of each group in the other program could erode. If the public is not supportive of student aid programs, and the broader segments of society are not included in or do not benefit from the program, the life expectancy of the program is likely finite, especially in either unsatisfactory economic times or when federal resources are constrained. Those who

support tax assistance—most likely middle- and upper-income families—have a substantial voice in the public policy process, while those who favor traditional student aid programs—low-income families—are not as visible in that process.

Tax-based approaches that seek to provide relief from the growing cost of education are an important and necessary tool in families' efforts to pay for college. But will these policies extend educational opportunity to those now outside of the system, or will they largely reward those who already have access? The comparative political and fiscal weight given to these policies should not come at the expense of traditional need-based student aid. Instead, actions must be taken to ensure that the spectrum of available aid opportunities is balanced among the interests of all students, and all citizens who have the desire to attend college. These efforts will result in public policies that promote the economic and social interests of the nation as a whole, as well as the individuals who are the direct beneficiaries of these policies.

INTRODUCTION

Public policy discussions about improving college affordability over the last several years have increasingly focused on proposals that utilize tax-based incentives. These proposals, ranging from state-based "prepaid tuition" programs to federal tuition tax deductions and tax credits, have been promoted as keys to improving college-going rates, which have long been associated with greater individual and social prosperity.

The history of national policy to help students pay for college has been driven by specific goals designed to meet defined areas of "national interest." At times these areas have been directly related to higher education, but at other times they have been more tangential. For example, the inception of federal student aid support—beginning with the National Defense Education Act in 1958—was promulgated by a perceived foreign policy/national security threat. The growth and progress of the Soviet Union in the fields of mathematics and science, and thus in weapons and technology, prompted the creation of public policies that provided incentives for more students to participate in postsecondary education, particularly in these fields.

The acceleration of federal involvement in providing assistance for higher education was related to other social policies and programs. The Great Society of the mid-1960s was promoted as a means of equalizing economic opportunities for minorities and other disadvantaged citizens. This equalization was sought through the passage of the Higher Education Act in 1965, by defining access to higher education as an important national goal.

At other times, however, political and ideological trends have had the opposite effect, resulting in the curtailment of financial aid. For example, the movement towards less government that was spearheaded by the Reagan Administration in the 1980s resulted in the targeting of student aid programs as a means of reducing federal expenditures. This reduction in expenditures was billed as a national priority, with the intention of stimulating economic growth.

The current policy environment offers further evidence of the interrelated nature of political/ideological trends and federal support for students. The budget cutting themes and austerity that have dominated national political debates over the past two years also have influenced the means by which support for higher education has advanced. The plight of middle-income families—stagnant incomes, spiraling higher education costs, limited resources for assistance—has captured a great deal of attention in the media and in statehouses and legislatures across the nation. In Washington, the two have combined to create higher education proposals that, in light of limited budget flexibility and declining opportunities for new programs and investment, utilize tax-based approaches to help students pay for college. This is in marked contrast to increasing support for need-based student aid, which requires policymakers to vote for higher spending through the budget appropriations process.

Current proposals to "increase" support for higher education focus not on new investment and new programs, but on creating incentives for increased individual and family responsibility—particularly among the middle class—and rewarding their efforts after the fact with tax breaks. With so much emphasis on balancing the budget and decreasing the deficit, tax-based measures such as deductions and credits for educational expenses hold the greatest political saliency.

But what would be the effects of these proposals on student aid and the policy process that guides the programs? Given that the primary target of this new assistance is middle-income families, questions about the federal government's longstanding commitment to the neediest students through student assistance have emerged. At the center of the debate is the question of whether there would be a tradeoff between investment in middle-income students through tax policy and investment in needier students through student aid.

However, that question and others are far from being answered. Many of these proposals have just begun the arduous journey through the legislative process. The scrutiny that these proposals must face should be grounded in a balanced discussion of the benefits and drawbacks of increased use of tax-based aid to pay for higher education. To inform the policy process, The Institute for Higher Education Policy and The Education Resources Institute (TERI) have prepared this report. The goal of the report is to provide the public, policymakers, and the higher education community with essential facts and information about the variety of tax-based methods available to help pay for college, and to compare these with need-based policies.

To meet this goal, the report serves as a "primer" on the various means through which tax-based policies have been promulgated to promote college affordability. The report reviews current,

past, and proposed policies and programs, and discusses who benefits from these policies, based on available government data. The report also reviews similar information about need-based grant aid, which is targeted to lower-income students.

THE CONTEXT FOR TAX AND STUDENT AID POLICIES

At the federal level, the discussion about increasing tax assistance for families paying for college is a recurring one that has surfaced each decade since the 1960s. Even in the debates that resulted in the creation of the major federal student aid programs, first in 1965 and then in the 1970s, tax credits and deductions were a major component of higher education policy discussions.

In 1965, as many supporters promoted tuition tax credits as a way to reimburse families from all income levels for expenditures for college, President Johnson opposed them in favor of grants. He believed that the government should focus its resources on those who would not be able to attend college without this assistance. Again in 1977-78, President Carter held off a strong push for tuition tax credits. A bipartisan effort from lawmakers sought to replace grant programs with the credits, since the current programs provided limited assistance to middle-income families. President Carter argued that the system of grants for low-income students and loans for middle-income students was more equitable than relying on the federal tax code for assistance in paying for college.[1]

The issue was raised yet again the next decade. The budget cuts forwarded by the Reagan administration in 1981 included proposals to replace the existing aid system with tax credits. In this instance, political opposition and budget constraints ultimately prevented the proposals from being passed.[2] In the 1990s, plans by both President Clinton and the Congress to utilize tax credits and/or deductions feature similarities to those that have been previously proposed.

Both the supporters and detractors of the current set of tax policy proposals base their arguments on some of the same points made in previous incarnations of these tax assistance/student aid debates. For example, a report from a task force appointed by the Committee on the Budget in 1977 to review education tax allowances cited the following as some of the major issues being considered:

- The financial burden of college costs for middle-income families;
- Consistency with current education policy and tax policy;
- The likely impact on tuition charges;
- Problems of administering an education tax allowance;

- The effect of new tax subsidy on support for existing aid programs; and
- The revenue loss from an education tax allowance.[3]

WHO GOES TO COLLEGE?

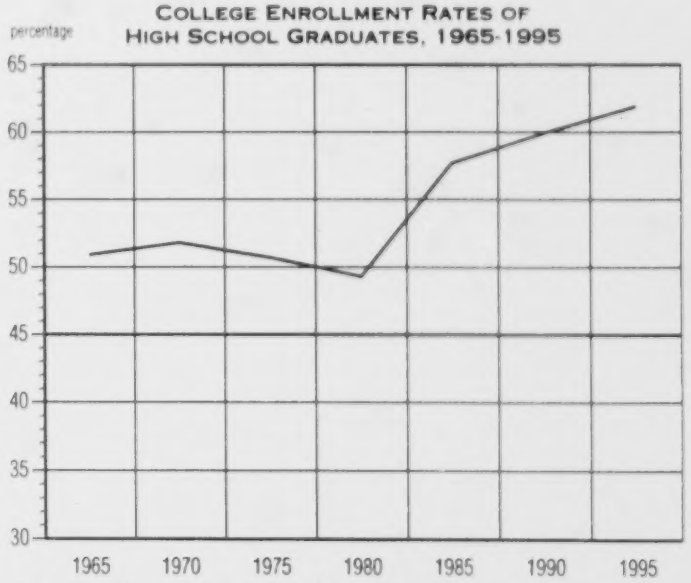
The explicit goal of both tax-based and student aid policy is to increase college attendance rates by easing the costs of paying for higher education. In other words, these policies are designed to ensure that those who have the desire and ability to go to college are able to do so, regardless of their income. Thus, before examining the data on the beneficiaries of tax and student aid policies, it is important to understand who goes to college now.

There is increasing evidence that the goal of increased educational attainment is being realized, albeit incrementally. For instance, the percentage of high school graduates going on to college has risen from 50.9% in 1965 to 61.9% in 1995. The number of college graduates has also grown over that same time period, from 792,656 in 1970 to 1,177,157 in 1994, a 49% increase.[4]

Prior to the expansion of federal support for higher education, college participation was limited to those families who could afford to send their children to college. A bachelor's degree was not as widely pursued; a high school diploma was seen as the key to economic success. College was viewed as something for the very rich and/or the very talented, but not the average family. Federal student aid programs that were formulated in the 1960s, and expanded in the 1970s, sought to address this disparity by providing funds that leveled the playing field so that students from all backgrounds, regardless of income, could have access to higher education. In the 1990s, this goal has taken on increased significance as the evolving workplace has made a college education necessary for economic prosperity.

Some success has been achieved towards this goal; over the history of major federal support for students, the number of minorities and students from lower-income families enrolled in higher education has

COLLEGE ENROLLMENT RATES OF HIGH SCHOOL GRADUATES, 1965-1995



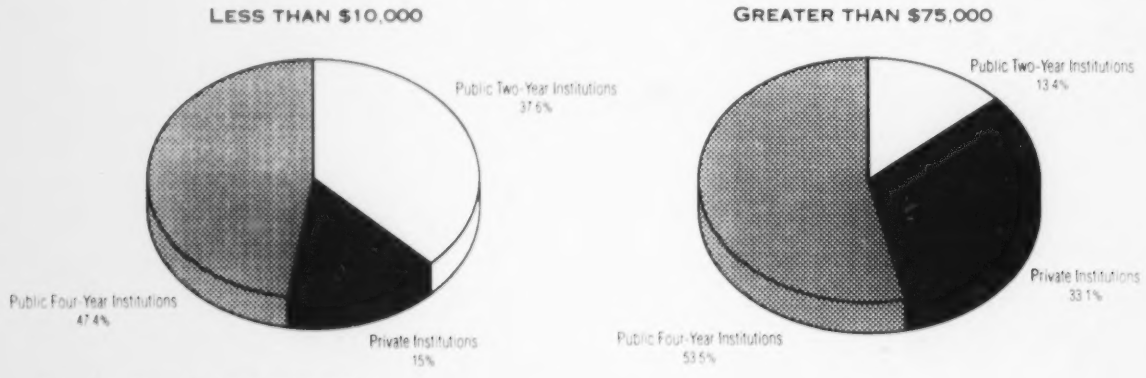
Source: *Digest of Education Statistics 1996*, National Center for Education Statistics, U.S. Department of Education, 1996

increased. But the growth has been modest. College-going rates by family income levels indicate that students from higher income families still have much higher college-going rates, while middle- and low-income families send their children to college at lower rates. According to Census Bureau data, the college participation rate in 1994 for students from the lowest quartile of family income ($0 - $22,033) was 58.2%, compared to a rate of 87.8% for students from the highest quartile of family income ($67,881 and above). Students from the two middle family income quartiles ($22,033 - $41,393 and $41,393 - $67,881) had college-going rates of 68.3% and 77.2%, respectively. Between 1979 and 1994, students in the lowest income quartile had increased their participation by 13.6%, the smallest of any of the other three income quartiles; the middle quartiles experienced a 16.1% and 16.2% increase, while participation by students in the highest income quartile grew by 20.5%.

The type of institution that students attend also varies greatly by family income level. Nearly 38% of students from families with incomes below $10,000 went to community colleges, 47% went to public four-year colleges and universities, and 15% attended private colleges and universities. In contrast, only 13% of students from families with incomes over $75,000 went to community colleges, 54% attended four-year public colleges, and 33% attended private colleges and universities.

Furthermore, analyses of bachelor's degree completion data show that in 1994, only 8% of students from the lowest income quartile would complete their degree by the age of 24. A significantly larger percentage of students in the highest income quartile would have received a bachelor's degree by age 24—79%.[5]

DISTRIBUTION OF COLLEGE ENROLLMENT BY FAMILY INCOME AND INSTITUTIONAL TYPE



Source: Postsecondary Education Opportunity, November 1995

These findings are even more troubling given recent research that has shown a family's socioeconomic status to be the most important indicator of whether a student will attend college. The 1988-94 National Education Longitudinal Study (NELS) reveals that 80% of 1993 high school graduates from the top 20% income group went on to college, but only half of those from the bottom 20% attended college. In addition, attendance by institutional type varied significantly by socioeconomic status: 48% of those in the lowest group attended two-year institutions, while 37% attended four-year institutions, compared to 23% at two-year institutions and 74% at four-year institutions among the highest group.[6]

The portrait of the incoming freshmen class further illustrates the socioeconomic makeup of college classrooms across the nation. According to the 1995 American Freshman Survey, students whose parents had incomes of $30,000 and below comprised just over one quarter of incoming freshmen—26.5%. Students in the $30,000 to $60,000 range, and those from families with incomes from $60,000 and above, each made up more than one-third of the new class—36.7%.[7] In comparison, the distribution of income among the overall population indicates that a greater percentage of citizens come from households with much lower incomes. Almost 40% of households have incomes under $25,000, and nearly half—47%—fall in the income range of $25,000 to $74,999. Only 13.6% of households have incomes greater than $75,000.[8]

WHO RECEIVES GRANT AID?

Much of the public policy discussions regarding tax-based approaches to paying for college rest on the supposition that many families who need help are not benefiting from the current student aid programs, especially those that award grant aid. A review of the two primary federal grant programs—the Pell Grant and the Supplemental Educational Opportunity Grant (SEOG) programs—and an analysis of information from a national database on how students finance their education reveals who receives grant aid.

Pell Grant Recipients

The Pell Grant program has served as the foundation for student aid packages. In the Pell program, the majority of recipients come from the lowest income groups. According to U.S. Department of Education data, in 1994-95 one quarter of dependent students and almost two-thirds of independent students who received a Pell Grant reported incomes between $0 and $9,000. Among all recipients in this income group, 37% attended two-year public institutions, 31% attended four-year public institutions, 16% attended proprietary institutions, 13% attended four-year private institutions, and 3% attended two-year privates. In the $9,000 to $30,000 income group, the vast majority of students were in the public sector: 35% were at both two- and four-year public institutions, while 17% were at four-year private institutions, 2% were at two-year private institutions, and 11% were at proprietary institutions.

Distribution of Pell Grant Recipients by Income Level, 1994-95

Family Income	Number of Recipients	Percent
$0 - $9,000	1,738,643	47.3%
$9,001 - $30,000	1,651,494	44.9%
$30,001+	284,830	7.8%

Source: *1994-95 The IV Federal Pell Grant Program End of Year Report*, Office of Postsecondary Education, U.S. Department of Education, 1996.

Irrespective of income, the largest number of Pell Grant recipients, 35.2%, attended two-year public institutions. The next largest group of recipients attended four-year public institutions, 33.5%, followed by four-year private institutions, 15.5%, proprietary institutions, 13.2%, and two-year private institutions, 2.6%.[9]

SEOG Recipients

The SEOG program is smaller than the Pell program. A campus-based program, it is designed to allow institutions to provide additional aid to the neediest students. Among dependent SEOG recipients, 31% have incomes below $12,000, 48% are in the $12,000 to $30,000 income range, and 21% have incomes above $30,000. The greatest amount of money—41%—is awarded to students at four-year private institutions, followed by students at four-year public institutions, 34%, two-year public institutions, 16%, and proprietary institutions, 10%.[10]

DISTRIBUTION OF SEOG GRANT RECIPIENTS BY INCOME LEVEL, 1994-95

FAMILY INCOME	NUMBER OF RECIPIENTS	PERCENT
$0 - $11,999	157,848	31.9%
$12,000 - $29,999	246,300	48.2%
$30,000+	106,492	20.8%

Source: *Federal Campus-Based Programs Data Book 1995*, Office of Postsecondary Education, U.S. Department of Education, 1996

NPSAS Data

Analyses of data from the 1992-93 National Postsecondary Student Aid Study (NPSAS) provide a broader perspective on who receives grant aid at the federal and state levels. According to NPSAS, of all undergraduate students who receive federal grant aid, 69% are students from families with incomes between $0 and $30,000. Twenty-six percent of recipients are from the $30,000 to $70,000 range, and the remaining 5% are from families with incomes over $70,000.

An analysis of federal grant recipients by income level and type of institution indicates that the vast majority of low-income students receive federal grant support, regardless of where they go for their education. For example, at public two-year institutions, 93% of those students with family incomes below $10,000 receive federal grant aid, as do 81% of those with incomes between $10,000 and $20,000. Similarly at four-year public institutions, 88% of those with incomes less than $10,000 receive federal grant aid, as do 74% of those in the $10,000 to $20,000

range. At private four-year institutions, 86% of those with incomes less than $10,000 receive federal grant aid, as do 74% of those in the $10,000 to $20,000 range.

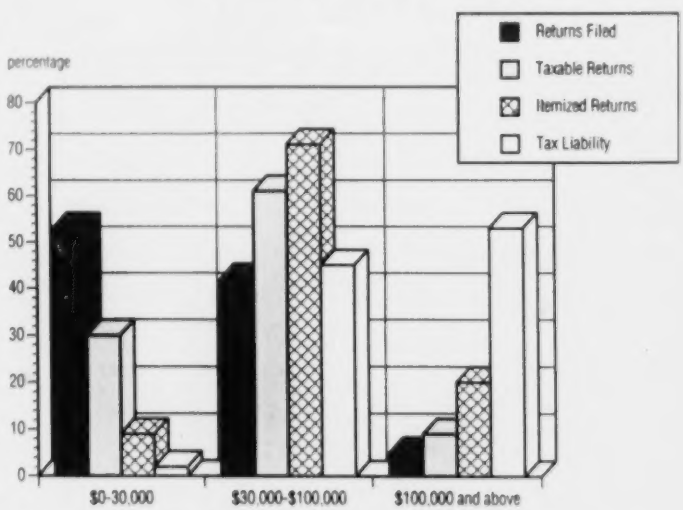
The same trends hold true for recipients of state grant aid. Seventy-four percent of all state grant recipients come from families with incomes less than $30,000. Only 24% of recipients have incomes in the $30,000 to $70,000 range, with 2% above $70,000.[11]

WHO BENEFITS FROM TAX POLICIES?

Income tax deductions and other tax-based measures seek to "reward" certain expenditure behavior that has been deemed desirable in terms of societal or public policy goals. In the case of proposals to use the tax code to provide assistance for families paying for college, it is an attempt either to reward parents' efforts to save for their children's education, or to reimburse a portion of their educational expenditures. Historically, tax deductions have been more beneficial to those taxpayers with higher incomes. There are several reasons for this, but three of the primary ones are that deductions applied on a scale will benefit those starting at a higher income base, lower-income families lack the discretionary income to engage in many of the activities being rewarded, and the tax system is intimidating and confusing for people who do not have the personal knowledge or other resources at their disposal to navigate their way through the system. Much like the financial aid process, familiarity with the necessary forms, the technical language, and the bureaucratic system are keys to maximizing the tax code's benefits and minimizing the required contributions. Middle- and upper-income taxpayers have much more at stake and are more likely to allot some of their resources to either gaining this knowledge and experience on their own, or enlisting the services of a professional.

A look at who files income taxes illustrates this point. In 1995, taxpayers with incomes under $30,000 filed 53% of all returns. These returns accounted for 30% of all taxable returns and only 9% of these taxpayers itemized. Moving up the income scale, persons in the $30,000

DISTRIBUTION OF FEDERAL TAX RETURNS BY INCOME, 1995



Note: Tax liability is the amount of taxes owed by an individual.
Source: *1996 Green Book*, Ways and Means Committee, U.S. House of Representatives, 1996

to $100,000 income range accounted for 42% of all returns, 61% of all taxable returns, and 71% of those who itemized deductions. In the $100,000 and above income category, taxpayers' returns were only 5% of the total number of returns filed, but represented 9% of those which were taxable, and 20% of itemized returns. Furthermore, from lowest to highest, these income categories accounted for 2%, 45%, and 53%, respectively, of the total tax liability.[12]

Earned Income Credit vs. Home Mortgage Deduction

An illustration of how taxpayers from different income groups utilize the tax code and its benefits is a comparison of the earned income credit versus the home mortgage deduction. The earned income credit is a program designed to return money to the working poor that would have been owed in federal income taxes. Persons who meet the eligibility criteria receive a credit against taxes; if the credit exceeds the amount of tax liability, the excess is paid back to the taxpayer. Recipients receive their credit when they file their annual tax returns, or certain individuals may elect to participate in the advance payment system and receive the credit in their paycheck. A credit of 34% is applied to taxpayers with one child and income between $6,330 and $11,610, with a maximum credit of $2,152. For those taxpayers with income greater than $11,610, the credit is phased out until it reaches zero at an income of $25,078. For taxpayers with more than one child, the credit is 40% for those whose incomes fall between $8,890 and $11,610. The maximum credit is $3,556 and is phased out to zero at $28,495.

According to the Joint Congressional Committee on Taxation, 18 million taxpayers were expected to participate in the earned income credit program in 1996. The total dollar amount of the claims was expected to reach $25.1 billion; 86% of this total will be refunded as a direct payment to families. Approximately 70% of the tax relief or refunds will be given to single parent head of household filers. The average credit received is expected to be $1,400.

Further breakdown of earned income credit recipients reveals that in 1996:

- 66.7% of all recipients of the earned income credit are from the $0 to $20,000 income range and account for 72.8% of the total amount awarded; and
- 32.5% of all recipients are from the $20,000 to $40,000 income group and receive 26.6% of the total amount awarded.[13]

In comparison, an examination of the mortgage interest deduction reveals a much different profile of users. Over 65% of American households own the home in which they reside; data on

home ownership by family income show that the majority of those in the remaining 35% are from lower-income levels.[14] The deduction of interest on home mortgages is the most popular itemization on federal tax returns. The tax code allows homeowners to deduct interest on either the purchase or improvement of a home limited to a value of $1 million, or interest on a home equity loan used for other consumer expenditures.[15]

In 1995, 21% of all tax returns (28 million total) claimed the mortgage interest deduction. A breakdown of those returns deducting home mortgage by income levels shows that a larger percentage of upper-income families claimed the deduction and received a sizeable portion of the total benefits reported. The mortgage interest deduction totaled $58.3 billion in 1995. Taxpayers with incomes over $200,000 represented 1.2 % of all taxpayers but received $12.6 billion—21.6% of the total amount deducted. Those with incomes greater than $100,000 account for 49.7% of the total amount deducted.

In addition, data on the mortgage interest deduction indicate that the amount of tax benefits per family is significantly higher for those in the upper-income brackets:

- 82.5% of all taxpayers with incomes over $200,000 take advantage of the mortgage interest deduction, with an average benefit of $9,763;
- 28.1% of all taxpayers with incomes between $40,000 to $50,000 claim the deduction, with an average benefit of $952; and
- 6.6% of all taxpayers with incomes between $20,000 to $30,000 utilize the mortgage deduction, with an average benefit of $502.[16]

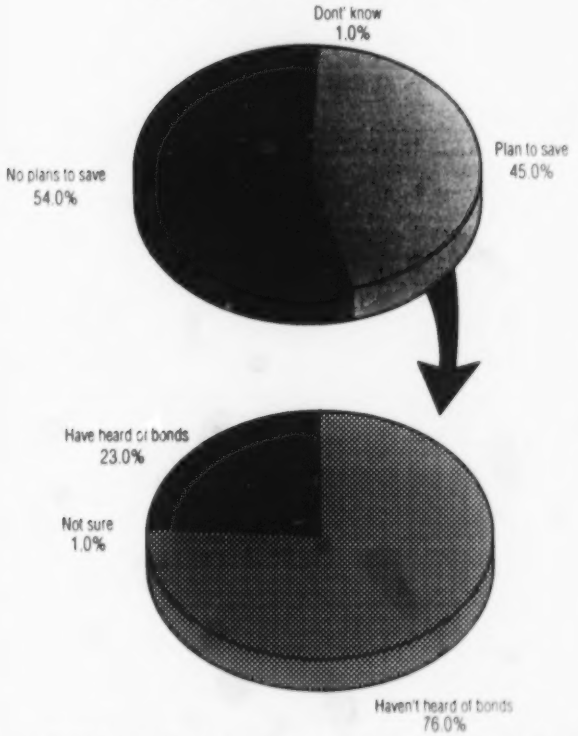
CURRENT TAX INCENTIVES

At the federal level, current efforts to improve college affordability through tax-related measures are concentrated in relatively minor provisions. The existing programs include Series EE Savings Bonds, and several employment-related educational assistance provisions in the tax code.

SAVINGS BONDS FOR EDUCATION

When it was created in 1988, the Series EE Savings Bond was heralded as an improved way for parents to save for their children's education. Savings bonds have always been a traditional college savings vehicle, but the Series EE bond includes a provision that allows interest earned to be partially or completely excluded from federal income tax if the bond is used to pay for higher education expenses. The owners of the bond are eligible for the exclusion if the expenses are for

PLANS TO SAVE FOR EDUCATION AND KNOWLEDGE OF SERIES EE SAVINGS BONDS, 1992



Source: *College Savings Issues*, U.S. General Accounting Office, Washington, DC 1994

themselves, their spouses or their dependents. If the owner's income falls within certain limits, the interest can be fully excluded; a phase-out range allows for partial exclusions along a scale. The present income limits are $49,450 for single filers for the full exclusion, and are phased out to no exclusion at $64,450. For married taxpayers filing jointly, the threshold is $74,200, and the exclusion is zero at $104,200.[17]

Since the program is relatively new, and savings bonds are traditionally held for an average of 10 years before they are cashed in, data on who is claiming the exclusion is very limited. A 1994 General Accounting Office (GAO) report on college savings issues found that:

- in 1991, 6,685 taxpayers had claimed the interest exclusion, for an estimated total of $510,000, and an average exclusion of $76; and
- in 1992, 11,200 taxpayers claimed the interest exclusion—an increase of 68%—for an estimated total of $1.5 million, and an average exclusion of $134.

The GAO report also cited a national survey conducted in 1992 for the U.S. Treasury about public awareness and the use of federal savings bonds. Data gathered in the survey provide a broader perspective of who uses savings bonds in general, and consumer awareness and interest in special education bonds in particular. The survey found that more than half of current owners and recent purchasers of savings bonds earned over $35,000 annually. Approximately one-third of the people who currently have general savings bonds bought them for the education of either their children or themselves, but only 10% of those who had redeemed bonds had used the money for education. When respondents were asked about saving for education, 45% said that they had plans to put aside money within the next few years. However, only 23% of those who had plans to save had heard of the education savings bond. Upon being informed of these bonds, 77% of those who planned to save for education said that these bonds are a good or excellent way to save for education in comparison to other plans. Although 84% said they were very or somewhat likely to buy the special education savings bonds, 39% felt that the eligible income levels for the exclusion should be raised or eliminated, 16% thought the levels should be low-

ered, and 44% thought the current levels were correct.[18]

These preliminary data seem to suggest that over time, use of the Series EE bond for education is likely to increase, particularly among middle-income families. The use of these bonds would most likely be even greater if the income limits were raised or removed.

EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

The tax provisions for employer-provided educational assistance are complex. There are several sections of the tax code that apply to the issue of reimbursing expenditures for education and training expenses, including: Section 127 - Educational Assistance Programs; Section 117 - Qualified Scholarships; Section 132 - Certain Fringe Benefits; and Section 62(a)(2)(A) - Reimbursed Expenses of Employees.

Section 127

Section 127 allows employees to exclude from their gross income, and thus taxes, the amount of educational assistance for expenses—such as tuition, fees, and books—that are either paid for directly by employers or reimbursed. Restrictions on the types of education that qualify as job-related classes are defined by the IRS; under the most recent version of the law, the benefits must be treated as taxable income unless the education or training meets the definition of job-related. The current limit for each individual employee is $5,250 annually.

Data on the use of Section 127, both by employers and employees, has been hindered by the uncertain status of the provision. Section 127 has never been made a permanent part of the tax code, and since it was enacted in 1979, it has expired and been renewed eight times. It was renewed again in 1996, with a provision to retroactively apply to 1995 benefits. Tracking participation information is further complicated by the method in which these "benefits" are reported: the tax benefits do not show up on the individual employee's return, but rather in reporting from employers. In 1990, the IRS introduced a supplement to Form 5500, Schedule F, which requires employers to report the number of eligible employees for Section 127 benefits, the number of employees who actually received assistance, and the amount/dollar value of assistance provided. In order for employers to be able to deduct these programs as an expense, the business must establish a formal education benefits program.

For each year from 1992 to 1994, employers filed over 3,200 returns which included Section 127 benefits. The amount of assistance provided to employees for education and training increased from $525.3 million in 1992 to $691.3 million in 1994.[19] Companies employing 250 workers or

more provided 99% of the total dollar amount of assistance reported to nearly all employees who received such assistance. While approximately 900,000 employees received assistance each year from 1992 to 1994, they represented only a handful of the eligible employees at companies that provided such benefits; the participation rate was steady for all three years, at 8 to 9%.[20]

The most recent data on Section 127 recipients from the 1993 NPSAS show that more than 73% of student recipients were undergraduates, and more than 95% were enrolled in degree or certificate programs. One third of the students were pursuing an associate degree, 23% were studying for a bachelor's degree, and 25% were working towards a master's or other graduate degree.[21]

Other Tax Code Provisions

The three other sections of the tax code that address employer-provided educational assistance are more technical in nature and are applicable to a narrower set of expenses for education. They are all permanent provisions of the Internal Revenue Code. Section 117 covers scholarship and tuition reduction for employees of educational institutions. The value of these benefits are excluded from gross income. Section 132 deals with job-related educational expenditures that would otherwise be considered a business expense—termed a "working condition fringe benefit". Employees can exclude the employer-provided assistance from their gross income. Finally, educational assistance that is included in Section 62(a)(2)(A) is more commonly known as employer tuition reimbursement plans.[22]

TAX CODE PROVISIONS FOR EMPLOYER-PROVIDED EDUCATIONAL ASSISTANCE

PROVISION	EXAMPLE	TYPE OF ASSISTANCE EXCLUDABLE	ELIGIBLE PERSONS	DOLLAR LIMIT
Section 127: Educational Assistance Programs	Employer directly pays for employee's educational expenses	Job- and non-job related	Employees only	$5,250
Section 117: Qualified Scholarships	Professor's child pays a reduced rate for tuition at the college	Job- and non-job related	Employees, spouses, and children	None
Section 132: Certain Fringe Benefits	Employer provides assistance for a class employee needs to retain current job	Job-related only	Employees only	None
Section 62(a)(2)(A): Reimbursed Expenses of Employees	Employer reimburses employee for education expenses on a pay-as-you-go basis	Job-related only	Employees only	None

STATE COLLEGE SAVINGS PLANS

At the state level, attempts to use tax-based methods for improving college affordability have focused on increasing families' ability to save and pay for their children's edu-cation. These efforts have most frequently taken the form of state college savings plans, which include savings bonds, savings accounts, or prepayment of college tuition. The College Savings Plans Network (CSPN), which was founded in 1991, works with states currently operating or planning to start college savings plans, and also tracks state and federal activities and legislation that affects the programs. CSPN's *Special Report on State College Savings Plans* shows that at least 25 states have savings programs of some type, including six which will begin operation during 1997. In addition, at least 21 other states are considering programs, either complementing existing programs or creating new savings type plans altogether.

Savings Bond Plans

Under savings bond plans, states sell bonds to individual families at a rate discounted from their face value. No interest is paid until the bonds mature—a range of 5 to 20 years depending on the program—and the interest earned is exempt from federal and state taxes. Eleven states currently have or have previously operated a savings bond program. The combined total sold under these plans through October, 1996 equals $1,345,836,860.

Savings Accounts

The second type of program is the savings account, or as it is called in many states, savings plan trust. Essentially, families set up a savings account with the state to save for their children's college education. The programs guarantee a minimum rate of return, and the contribution amount varies, as does the mandatory period of deposit. These plans do not guarantee that the rate of return will cover the growth rate in the cost of the child's college education. Three states currently operate savings plan trusts, but there is no existing data on how much families have saved through these programs.

Prepaid Tuition Plans

The third type, and perhaps the most well known, is the prepaid tuition plan. The "pay now, learn later" premise of these programs is that if parents pay in advance for their children's education, the state will guarantee that their investment will meet the cost of tuition—and under some plans fees and other educational expenses—in the future. Of all state college savings plans, prepaid tuition plans offer the most tax advantages to participants, as they are usually set up to be tax-exempt from state and federal taxes on interest earnings. The structure, eligibility, and benefits offered in the programs vary from state to state. Generally, participants buy tuition

credits or purchase contracts for two- or four-year institutions that can be paid for through lump-sum installments or monthly payment plans. There is also great variation in the use of the benefits: under some programs the rates are guaranteed only at in-state public institutions, while others extend to private and out-of-state institutions at differing values. In addition, standard practices for cancellations and refunds fluctuate in different states.

The first modern program was started in Michigan. Although its growth was slowed by legal and tax complications, the Michigan program has served as model for other states that have initiated prepaid programs. According to CSPN, 13 states have prepaid tuition programs. Over 621,000 contracts have been sold in 8 states since 1988.

In those states in which participants have begun to "cash in" their benefits, limited data has revealed the attendance patterns of purchasers. In Michigan, 5,548 contracts had been used as of 1995, with 4,180 students attending in-state public institutions, including community colleges. The remaining 1,368 were either at private or out-of-state institutions, or had terminated their contracts. In other states where program participants are not yet enrolling in institutions, information on the type of benefits that participants are purchasing reveal possible attendance patterns. In Florida, almost three quarters of the contracts sold are for the costs at four-year institutions. Twenty-one percent of the contracts are for the state's 2+2 program—two years at a community college plus two years at a state university— while another 5% have bought contracts for just community college attendance. In Pennsylvania, almost two-thirds of the benefits are for state-related universities, one-third are for institutions in the state higher education system, and about 2% are for community colleges. Data from other states show similar patterns: the majority of participants are purchasing benefits for the four-year institutions.[23]

GAO has conducted some of the most extensive research on state prepaid tuition programs. According to an August, 1995 report, seven states—Alabama, Alaska, Florida, Michigan, Ohio, Pennsylvania, and Wyoming—had programs up and running by 1993. Their analysis found that among these programs, lower-income families are underrepresented when statewide income distributions are compared to participation levels.

The GAO study determined that participation levels were linked to the college tuition levels in the state: participation was generally higher in states where the tuition was more affordable initially. By dividing a state's tuition cost by the median income for families in the state with children under age 18, GAO produced the percentage of family income needed to cover the costs of education. These percentages were then compared with the average annual participation rates

in the prepaid programs. Among the active states, as the percentage rose, the participation levels decreased. For example, in Alaska, where 3.84% of family income was needed, the participation level was 2.07%, the highest of all seven states.[24]

While prepaid tuition programs have generally been considered successful, there are several concerns that have been raised, including:

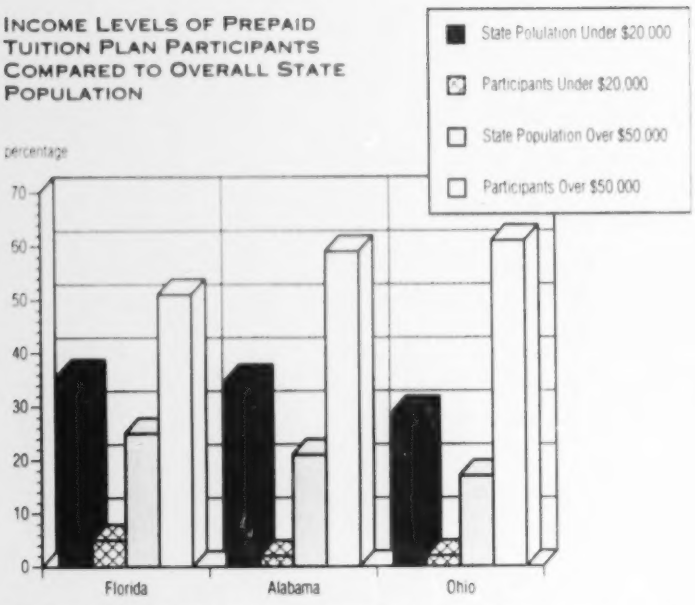
- *The tax status of prepaid tuition programs.* When the Michigan program began in 1986, interest earnings were designed to be tax-exempt from both the state and federal governments. The Internal Revenue Service disagreed and several years of legal battles ensued. In 1996, the status was clarified when the IRS ruling was overturned in court. In addition, as part of the Small Business Protection Act of 1996, qualified prepaid programs will be considered tax-exempt if they adhere to specific federal requirements.

- *Low levels of participation among low-income families.* Few states gather mandatory information on participant's income, but the limited data reveal that purchasers are most frequently in the middle- and upper-income ranges. In Kentucky, 61% of the families have incomes higher than $50,000, while only 10% are from families with incomes under $25,000. In Florida, 51% of the purchasers have incomes above $100,000, and another third have incomes between $50,000 and $100,000; only 5% are from families with incomes less than $25,000. In Alabama, almost 60% of participants have incomes above $50,000, compared to only 10% below $25,000. In Texas, half of the participants are in the $50,000 to $100,000 range, with just 5% under $25,000.[25]

The GAO study compared state family income information to data on prepaid program participants in Florida, Alabama, and Ohio. While over half of the purchasers in Florida had incomes above $50,000, only 25% of all families with children under the age of 18 were in this income bracket. The 5% of participants with incomes under $25,000 does not compare favorably to the percentage of families within the state in that income group, 36%. GAO found similar results in Alabama and Ohio. About 60% of the purchasers in Alabama and Ohio were families with incomes over $50,000, compared to only 20% of families with children statewide in the same income group. About 2% of the participants in these states had incomes below $20,000, while 30-35% of families with children in these states were in this low-income group.[26]

For many supporters of these programs, the lower participation rates of low-income families are not problematic, since most prepaid programs were established to appeal to middle-income families

INCOME LEVELS OF PREPAID TUITION PLAN PARTICIPANTS COMPARED TO OVERALL STATE POPULATION



Note: Income data in Ohio was collected for $21,000 and below, and $51,000 and above.
Source: *College Savings: Information on State Prepayment Tuition Programs*, U.S. General Accounting Office, 1995

who are most frequently caught in the crunch of escalating college costs and stagnant income. These families often have limited financial aid options under the current system, short of continuing to borrow to pay for their children's education. The fact that few low-income families participate in these programs is attributable in part to a lack of discretionary income. Some states have tried to remedy this situation by lowering the monthly payments to more affordable levels, creating loan programs that help low-income families make lump-sum payments, and offering prepaid tuition scholarships to families. But in most cases, states have found that trying to expand the participation of lower-income families has been difficult due to funding problems and the fact that the added administrative requirements impede the intended simplicity of these programs. In states where opponents objected to establishing prepaid programs because of the inability of low-income families to participate, policymakers have declared that the popularity of these programs will not detract from the support that grant and other need-based programs receive in the statehouses.

PROPOSED FEDERAL TAX POLICIES

While increased use of the tax code for assistance in paying for college has been a frequent topic of education policy discussions over the past three decades, the current policy environment features an unprecedented number of proposals from both Congress and the President. The proposals to change federal tax policies to greater benefit families paying for college can be divided into two groups: proposals that would restore favorable tax policies that were removed in the sweeping 1986 tax reform, and proposals that would create new tax code provisions.

"Restored" Tax Policies

Several proposed modifications to the current federal tax code seek to address changes made in the 1986 tax reform. Part of a broader effort designed to close loopholes in order to apply more standard rates of taxation, the Tax Reform Act of 1986 had a profound impact on the treatment of higher education expenses. Two of the larger pieces affected were the deductibility of student loan interest and the treatment of scholarships and fellowships.

Deductibility of Student Loan Interest

Prior to the 1986 reform, taxpayers could deduct interest paid on all types of loans, including student loans. But the legislation eliminated that provision for all types of loans. The only interest deduction remaining for students and families paying for college is resources derived from home equity loans, which along with the home mortgage interest deduction, was not changed in 1986. Under the home equity provision, interest on borrowing for any consumer purchase is deductible, so parents may borrow against the equity of their home, use the money to pay higher education expenses for their children, and deduct the interest paid.

In the last two sessions of Congress, legislation has been introduced that would restore the deductibility of loans, but none of the proposals went far in the legislative process. As the 105th

CURRENT AND PROPOSED TAX-BASED ASSISTANCE FOR HIGHER EDUCATION

STATUS	PROVISION	DESCRIPTION
Current Code	Series EE Savings Bonds	Federal savings bonds; interest earnings exclusion if bond used for education
Current Code	Employer-Provided Educational Assistance	Four tax code provisions covering deduction of education/ training expenses and benefits
Current Code	State College Savings Plans	Interest earnings from state-administered pre-paid tuition plans are tax-exempt
Removed in 1986 Tax Reform; Proposed	Deduction Of Student Loan Interest	Payments of interest on federal student loans are deductible for limited period of time
Removed in 1986 Tax Reform; Proposed	Exclusion of Scholarships and Fellowships for Taxable Income	Income from student aid awards is not considered taxable, even if used for living expenses
Proposed	Expanded IRAs/ Special Education Savings Accounts	Penalty-free withdrawal from account allowed to pay for education expenses
Proposed	Tuition Tax Credits	Credit for education expenses against income taxes owed
Proposed	Tuition Tax Deductions	Deduction of education expenses from taxable income

Congress begins, several members of Congress have introduced new pieces of legislation regarding the student loan interest issue. Central to most of the proposals has been a provision that would allow the interest paid on federal student loans to be deducted from taxable income for an initial period once the student has entered repayment. Although the length of this period varies among the different pieces of proposed legislation, it usually covers the first two years of repayment, and income level ranges determine eligibility for the deduction.

The increased amount of borrowing that students and their parents have taken on in the last few years to pay for college has increased the significance of this issue. Some proponents point to the natural relationship between asking students to take on larger loans and providing tax benefits for repayment.

According to the Congressional Research Service, three types of taxpayers would benefit from a student loan interest deduction: 1) parents who are homeowners would not have to utilize their home equity to deduct interest and therefore would not have to risk their homes or pay additional fees to pay for their children's education; 2) parents who reside in states with high taxes would not need to own a home to be able to profit from the deduction; and 3) students in high-cost graduate and professional programs with large loan payments could receive relief.

However, opponents of the deduction raise concerns about the disproportionate benefits to individuals in higher tax brackets, and the inability of young graduates to take advantage of the assistance since their initial salaries would be low. By the time their incomes

had risen to a level at which the interest deduction would eclipse the standard personal deduction, the interest due on the loans would be smaller, thus reducing the benefit.[27]

TREATMENT OF SCHOLARSHIPS AND FELLOWSHIPS

The 1986 Tax Reform changed the way in which scholarships and fellowships were treated in the calculation of taxable income. Prior to 1986, a scholarship or fellowship received by students working towards a degree was not included in the their taxable income. Students not in a degree program could exclude up to a certain amount monthly for approximately three years. But there was a great deal of confusion, particularly for students at the graduate level, regarding funds received for teaching assistantships and research. The 1986 tax legislation made three key revisions to the manner in which scholarships and fellowships are treated in the tax system: 1) only degree candidates may exclude a scholarship or fellowship from income—leaving postdoctoral students liable for taxes; 2) only the amount of an award up to the total allowable educational expenses—tuition and required fees, books and equipment—can be excluded; and 3) any portion of the award that is compensation for services performed—such as student teaching and research—are subject to taxes. These changes are particularly difficult for graduate students, whose fellowship awards often provide for their room and board.

Restoring favorable tax treatment for scholarships and fellowships has been included in some legislative packages in the past three years. However, it has not been as prominent an issue as student loan interest deductibility, particularly given the increased amount of borrowing by students at the graduate level.[28]

NEW TAX CODE PROVISIONS

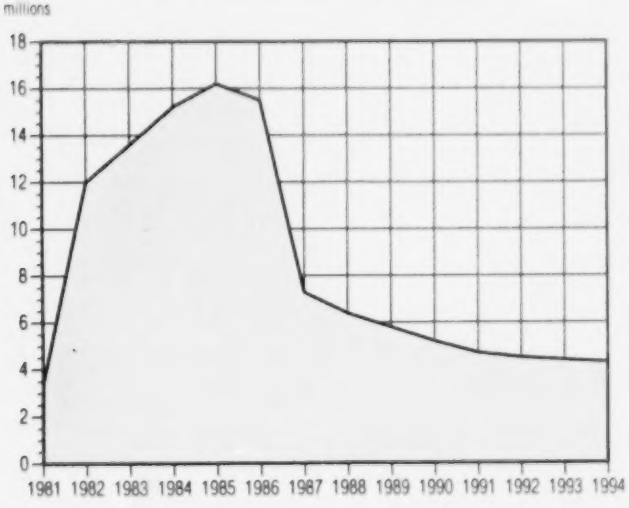
Like those tax policies that many policymakers would prefer to see restored, many of the "new" proposals have antecedents in previous or current tax law. The new proposals are distinct because the vehicle or instrument to implement them does not currently exist.

EDUCATION IRAS

Among the "new" provisions is one hybrid that combines the expansion of individual retirement accounts or IRAs, and/or the creation of new "super IRAs" or education savings accounts. The intent of these provisions is to encourage saving for college education and to increase flexible use of money put into such vehicles as IRAs without penalty.

IRAs have long been a popular alternative to bank-based savings accounts and employer-provided retirement plans. Prior to the 1986 reform, anyone could deduct contributions to an IRA, even if they participated in an employer-sponsored retirement plan, regardless of income. The result was extraordinary growth in the contributions to IRAs: the number of tax returns using a deduction for contributions to an IRA climbed from 3.4 million in 1981 to 16.2 million in 1985. In dollar terms, this was a jump from $4.8 billion in 1981 to $38.2 billion in 1985. However, the percentage of taxpayers contributing to IRAs was much greater among those with higher incomes. In 1985, 13.6% of taxpayers with incomes between $10,000 to $30,000 contributed, versus 74.1% of taxpayers with incomes between $75,000 to $100,000.

TAX RETURNS CLAIMING DEDUCTION OF IRA CONTRIBUTIONS, 1981-94



Source: *1996 Green Book*, Ways and Means Committe, U.S. House of Representatives, 1996

The reform reinstated income caps on who could contribute and claim the deduction, and consequently, IRA contributions fell dramatically. From their peak in 1985, the number of tax returns claiming the deduction fell to 7.3 million in 1987, and then still further to 4.3 million in 1994, the most recent year for which data is available. The total IRA deductions in 1994 equaled $8.4 billion. Participation by low-income contributors dropped at a much higher rate than the changes would have warranted, since they would have only marginally affected those taxpayers with income below $30,000. Furthermore, although the deduction was originally created to provide assistance for those citizens who could not participate in a tax-protected program offered by an employer, research indicates that higher rates of participation occur for those taxpayers who are covered by their employer's plan. In 1987, only 10% of those persons without coverage contributed and claimed the deduction, while 15% of those who had coverage contributed.[29]

The proposals for expanded use of IRAs focus on increasing eligibility for the IRA deduction and creating either what is known as a "super IRA" or some other type of education savings account. Under the Clinton Administration's proposal, the income limits for claiming the deduction for contributions would be raised to $70,000 to $90,000 by 1999 and indexed for inflation, as would the annual $2,000 contribution limit in increments of $500.[30] Taxpayers eligible for the IRA deduction would be able to invest in the special IRAs. These new savings vehicles would allow

for penalty free withdrawals for "qualified expenditures" such as education expenses, the purchase of a first home, or catastrophic medical expenses. These special IRAs would not feature a deduction, but the deposit period would be shorter and earnings would not be taxed. The President's proposal to expand IRAs would reduce revenues by $14 billion over 7 years.[31]

There have been numerous Congressional proposals to expand the use of IRAs for education, ranging from American Dream Savings Accounts (ADSA) to penalty-free withdrawals from 401(k) plans. Variations in these proposals include the removal of income eligibility limits on the deduction, and a provision which would allow taxpayers to put $2,000 in both a regular IRA and an ADSA. Withdrawal for the same type of expenditures allowed under the special IRAs would be permitted.

The goal of expanding access to IRAs and allowing penalty-free withdrawals for certain expenditures is to expand the amount of savings that American taxpayers achieve. Critics argue that these programs would not stimulate new savings, but rather result in a transfer of existing taxable savings. Of the two vehicles—the IRA in which the tax benefits are front-loaded and taxes are deferred, and the special IRA in which the tax benefits are back-loaded—analysts suggest that the front-loaded benefit might have a greater impact because taxpayers can "see" the benefits each year when they file, and the force of the penalty for withdrawal would inspire reduced consumption. The back-loaded instrument is more likely to prompt a transfer of savings from another type of savings, not reduce consumption.

Furthermore, these changes in the IRA programs would benefit upper-income families more. Taxpayers facing higher marginal tax rates would receive more benefit per dollar of IRA deduction than would a low-income taxpayer facing lower marginal rates.[32]

Tuition Tax Credits and Deductions

Since 1995, the Clinton Administration and members of Congress have forwarded several proposals that have incorporated tax provisions into a package of increased support for education. The President's two most visible proposals have been a tax deduction for tuition expenditures and a tax credit that equals the approximate average tuition at a community college. The deduction has been promoted as additional assistance for the middle-class families who usually receive limited federal assistance to pay for college. The proposed tax credit—called Hope Scholarships, after a program in Georgia of the same name—aims at increasing access to college by making the 13th and 14th years of education affordable for all.

Tax Deductions

The proposed deductions for tuition expenditures would allow taxpayers to annually deduct up to $10,000 in education expenditures—regardless of whether or not they itemize—for themselves and their dependents for an unlimited number of years. The income limits of the tax deduction match the levels proposed for the expanded IRAs: the deduction would be phased out for single filers with income between $50,000 and $70,000 and for joint filers in the $80,000 and $100,000 income group. When filing their annual returns, eligible taxpayers would simply deduct the total amount of qualified expenditures for education from their income and then pay taxes on the remaining income. Allowable expenditures include tuition and fees for students enrolled at least half-time, but not expenses for food, lodging, or transportation and other living expenses. The deduction would not include student loans, since the student's expenses would not be incurred until they entered repayment. In addition, the deduction would be reduced by the total amount of any scholarships or fellowships received.[33]

Tax Credits

The Hope Scholarship proposal would provide a tax credit for families up to the national average for tuition at community colleges—currently $1,500. The credit could be applied to tuition and fees at any college for up to two years; students attending half-time could receive a $750 credit annually until they have completed the equivalent of two full years of college. The same income levels that restrict the use of the tax deduction also apply to the tax credit; in addition, to retain the credit for the second year, students would have to earn a "B" average or a 2.75 GPA in their first year. Eligible taxpayers would figure out the amount of taxes owed, subtract the credit, and the remainder would be the taxes owed. The amount of any Pell Grant award would be subtracted from the $1,500 credit prior to subtracting it from the tax liability. If the Pell award was greater than $1,500 or if recipients had no tax liability, they would not receive any credit.[34]

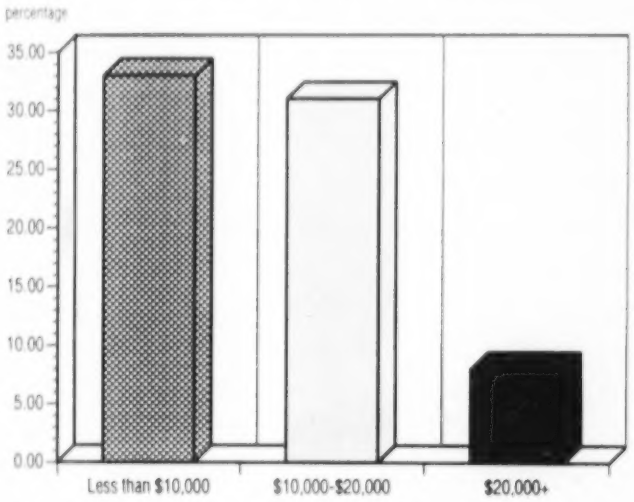
Policy Issues Concerning Tax Credits and Deductions

One of the concerns that has consistently been raised is that these kinds of programs may not increase access to higher education but could instead reward families and students who would most likely attend college without the tax incentive. The Congressional Budget Office (CBO) estimates that about 60% of the students eligible to claim the deduction would come from families with income of $50,000 or less. But the 40% of students from families with incomes higher than $50,000 are more likely to have higher tuition expenses and would therefore account for about 50% of the total amount deducted through the program. CBO calculates that those families in the 28% tax bracket would save $2,800 in taxes, but families in the 15% bracket would only save $1,500.[35] However, in preparation for inclusion in the FY 1998 Budget, the Adminis-

tration has modified their proposal to allow for a simultaneous increase in the maximum Pell Grant award to address the needs of low-income students.

For student from middle- and higher-income families—who are likely to get better grades due to better elementary and secondary education experiences and opportunities—access is not a major concern. Colleges and universities compete fiercely for the highest performing students, using scholarships and institutional aid packages to win them over. In past few years, many institutions have increased their merit-based aid and retreated from need-blind admissions policies, two trends that have received significant coverage in the national media.[36]

PERCENT OF INSTITUTIONAL AID BUDGET DEVOTED TO MERIT-BASED AID BY INSTITUTIONAL COST, 1993-94



Source: *Report on the Results of the Membership Survey of Need-Blind and Need-Conscious Admission Policies*, National Association of College Admission Counselors, May 1994

Furthermore, the assistance provided through the deductions and credits would come after taxes had been filed in April, more than half a year after tuition was paid for the fall semester and over a year and a half after the spring semester. In addition, the deduction would have to be taken in the year in which educational expenses were incurred, which would provide little assistance to students paying their own way through college with student loans.

Other aspects of these proposals that have generated concern include:

- *Tuition increases.* A common complaint is that these tax incentives could provide institutions with an incentive to drive up tuitions to capture more revenue. This is of particular concern for the tax credit; those community colleges with tuition below the national average might raise their tuition to that level. If this were to happen, the poorest student's access would be reduced even further.
- *IRS involvement.* Some analysts have questioned whether the IRS has the interest or expertise to assess issues concerning academic progress. For example, IRS verification of student attendance status, an important component of the work performed by the U.S. Department of Education for its need-based aid programs, would need to be conducted.
- *Academic performance.* Proposals such as the HOPE Scholarship also add a layer of complexity by requiring that specific academic standards be met. The validation of grades or other academic indicators could be a complex and time consuming process.

CONCLUSION

The emergence of tax-based methods to improve college affordability hold great promise for helping reduce the burdens that students and families face in paying for college. The public focus on increasing investment in higher education as a means of enhancing the nation's economic and social prosperity represents a sharp turn from policy discussions in recent years, which focused on the limited governmental resources available for such "discretionary" expenses.

Nevertheless, the dramatic surge in interest about tax-based methods also poses a challenge. The challenge is to find ways to promote affordability for middle-income families—the explicitly intended beneficiaries of most of these tax policies—without detracting from efforts to support access for those with the greatest need. This will not be an easy task because middle- and upper-income families rely substantially on tax-based methods of government assistance, which have significant political and policy advantages. These include:

- **The Budget Process:** Tax provisions, once enacted, do not have to receive authorization and appropriations each year; student aid provisions are not only subject to the annual budget process, but face competition for money within the discretionary portion of the budget as well. In an era of limited resources, student grant aid funds are placed on the table each year, spawning a fight to maintain funding and creating formidable obstacles to securing any new funding. Furthermore, expanded use of tax provisions means a loss of federal revenues that puts an even greater strain on the budget process. The revenues must either be made up by new revenues in the form of increased taxes—highly unlikely in the current political environment—or through further cuts in discretionary spending, placing expenditures for student aid in an even more precarious position.

- **Oversight:** Tax provisions are less frequently reviewed. When provisions are revoked, it is usually due to funding constraints, rather than lack of participation or effectiveness, or

even fraud and abuse. Student aid programs not only endure the scrutiny of authorizing and appropriations committees in both chambers of the Congress, they must also comply with oversight of program administration from certain committees and face a complete review every five years when the Higher Education Act is reauthorized.

- **Public Support:** If the needs of lower- and middle-income families for assistance in paying for college are addressed through different measures, the support for inclusion of each group in the other program could erode. If the public is not supportive, and the broader segments of society are not included in or do not benefit from a program or a particular investment of taxpayer money, the life expectancy of the program is finite, especially in either unsatisfactory economic times or when federal resources are constrained.

- **Political Will:** The capacity of politicians and policymakers to support a program arises from a combination of their own opinions and their perception of their constituents' views. By dividing assistance for college into two distinct vehicles, support for student aid is split into two groups: those who support tax assistance, most likely middle- and upper-income families, who benefit from this type and who have a substantial voice in the public policy process; and those who favor traditional student aid programs, low-income families who receive the larger shares of grant aid, who are not as visible in that process process.

Tax-based approaches that seek to provide relief from the growing cost of education are an important and necessary tool in families' efforts to pay for college. But will these policies extend educational opportunity to those now outside of the system, or will they largely reward those who already have access? The comparative political and fiscal weight given to these policies should not come at the expense of traditional need-based student aid. Instead, action must be taken to ensure that the spectrum of available aid opportunities is balanced among the interests of all students, and all citizens who have the desire to attend college. These efforts will result in public policies that promote the economic and social interests of the nation as a whole, as well as the individuals who are the direct beneficiaries of these policies.

ENDNOTES

[1] The compromise reached between the Carter administration and Congress was the creation and passage of the Middle Income Student Assistance Act (MISAA) in 1978. MISAA effectively opened the federal student loan programs to all students regardless of need.

[2] Lawrence E. Gladieux and Thomas R. Wolanin, *Congress and the Colleges* (Lexington, MA: D.C. Heath and Company, 1976); and Gladieux and Arthur M. Hauptman, *The College Aid Quandary* (Washington, DC: The Brookings Institution, 1995).

[3] Committee on the Budget, U.S. House of Representatives, *Task Force on Tax Expenditures, Government Organization, and Regulation on College Tuition Tax Credits*, 1977.

[4] U.S. Department of Education, National Center for Education Statistics, *Digest of Education Statistics, 1996* (Washington, DC: Government Printing Office, 1996).

[5] Thomas G. Mortenson, "Educational Attainment by Family Income 1970 to 1994," *Postsecondary Education Opportunity*, Number 41, November 1995.

[6] U.S. Department of Education, National Center for Education Statistics, *National Education Longitudinal Study 1988-94, Descriptive Summary Report* (Washington, DC: Government Printing Office, 1996).

[7] Linda Sax, et. al, *The American Freshman: National Norms for Fall 1995* (Los Angeles: UCLA, Higher Education Research Institute, 1996).

[8] U.S. Bureau of the Census, *Statistical Abstract of the United States: 1996* (Washington, DC: Government Printing Office, 1996).

[9] U.S. Department of Education, Office of Postsecondary Education, *1994-95 Title IV/Federal Pell Grant Program End of Year Report*.

[10] U.S. Department of Education, Office of Postsecondary Education, *Federal Campus-Based Programs Data Book 1995*.

[11] U.S. Department of Education, National Center for Education Statistics, 1993 National Postsecondary Student Aid Study (NPSAS: 93), Undergraduate Data Analysis System.

[12] Ways and Means Committee, U.S. House of Representatives, *The 1996 Green Book* (Washington, DC: Government Printing Office, 1996).

[13] An additional 0.8% of recipients are from the $40,000 to $75,000 income levels; these recipients account for approximately 0.6% of the total amount awarded. *1996 Green Book*, 1996.

[14] *Statistical Abstract of the United States*, 1996.

[15] Internal Revenue Service, *Home Mortgage Interest Deduction*, Publication 936, 1996.

[16] Joint Committee on Taxation, U.S. Congress, 1996.

[17] U.S. Department of the Treasury, Bureau of the Public Debt, "Purchasing Savings Bonds for Education," 1996.

[18] U.S. General Accounting Office, *College Savings Issues* (Washington, DC: Government Printing Office, 1994).

[19] The increase in the dollar amount of assistance provided under Section 127 may be related to the greater percentage of employer returns reporting assistance. In 1992, employers filed 3,556 returns, 65% of which reported the actual amount of assistance they provided to employees. That reporting rate increased to 80% in 1994.

[20] U.S. General Accounting Office, *Tax Expenditures Information on Employer-Provided Educational Assistance* (Washington, DC: Government Printing Office, 1996).

[21] National Association of Independent Colleges and Universities, *Who Benefits from Section 127: A Study of Employee Education Assistance Provided under Section 127 of the Internal Revenue Code* (Washington, DC: NAICU, 1995).

[22] *Tax Expenditures Information on Employer-Provided Educational Assistance*, 1996.

[23] College Savings Plans Network, *Special Report on State College Savings Plans* (Lexington, KY: The Council of State Governments, 1996).

[24] U.S. General Accounting Office, *College Savings Information on State Tuition Prepayment Programs* (Washington, DC: Government Printing Office, 1995).

[25] *Special Report on State College Savings Plans*, 1996.

[26] *College Savings Information on State Tuition Prepayment Programs*, 1995.

[27] Louis Alan Talley and Bob Lyke, *Tax Allowance for Interest Payments on Educational Loans: Data and Discussion of Issues* (Washington, DC: Congressional Research Service, 1992).

[28] National Association of Independent Colleges and Universities, *Tax Treatment of Scholarships and Fellowships* (Washington, DC: NAICU, 1992).

[29] *The 1996 Green Book*, 1996.

[30] In 2000, the income limits will be raised to match the limits proposed in the Administration's tax deductions and credits.

[31] Congressional Budget Office, *An Analysis of the President's Budgetary Proposals for Fiscal Year 1996* (Washington, DC: Government Printing Office, 1996).

[32] *Ibid.*

[33] Materials produced by the U.S. Department of Education, 1996 and 1997.

[34] *Ibid.*

[35] *An Analysis of the President's Budgetary Proposals for Fiscal Year 1996*, 1996.

[36] National Association of College Admission Counselors, *Report on the Results of the Membership Survey of Need-Blind and Need-Conscious Admission Practices* (Washington, DC: Sequitur Corporation, 1994).